# 1. Assessment of the Fiscal Stance

## Key Messages

- The Irish economy is recovering strongly with GDP growth in 2015 well above its estimated underlying long-run potential rate. While there is likely to be some spare capacity in the economy at present, as reflected in the current high level of unemployment, the nature and pace of the recovery underway should see the disappearance of the demand shortfall in the economy in the near term. While economic recovery is helping to improve the public finances, Ireland's high level of debt following the crisis means there is limited room for manoeuvre in the event of an adverse shock. Reducing the debt to safer levels must remain a key policy priority.

- While the planned fiscal stance from 2016 meets the requirements of the fiscal rules, the Council assesses that the decision to loosen the fiscal stance in 2015 was a deviation from prudent economic and budgetary management. *Budget 2016* showed an increase in government expenditure for 2015 of €1.5 billion compared to the projection in *SPU 2015.* This more expansionary stance than planned in the April *Spring Economic Statement (SES)* keeps the deficit and debt higher than could have been achieved and provides an unnecessary stimulus to an already fast-growing economy. Had the better than expected tax revenues in 2015 been used for deficit reduction rather than higher spending, a balanced budget could have been achieved at least one year earlier than forecast in *Budget 2016.*

- *Budget 2016* contained a €1.5 billion package of spending increases and tax cuts in line with the *SES*. As this package comes on top of the increase in spending for 2015, the fiscal stance in 2016 is less prudent than planned in the *SES*. Nevertheless, government revenues in 2016 are forecast to grow at a higher pace than non-interest government spending by some margin, which is appropriate given the on-going recovery. The Budget projections signal an intention to comply with the Preventive Arm of the *SGP* and the domestic Budgetary Rule from 2016, which is consistent with prudent policy.

- The fiscal forecasts in *Budget 2016* do not provide a meaningful anchor for medium-term budgetary planning. Expenditure projections imply a large decline in the ratio of government spending to GDP of over 5 percentage points by 2021 that is not realistic given underlying expenditure pressures that are likely to emerge in the coming years. The absence of a realistic medium-term plan for the public finances is of serious concern, in particular given the weaknesses in the Government's new system of multi-annual expenditure ceilings.

## 1.1 Introduction

The Fiscal Council has a mandate under the *Fiscal Responsibility Acts* 2012 and 2013 to assess the Government's fiscal policy stance, including with reference to the requirements of the *Stability and Growth Pact (SGP)*. The sections below draw on the analysis in later chapters in assessing the fiscal stance in *Budget 2016*. The Council's assessment is informed by the extent of compliance with the fiscal rules along with a complementary economic assessment that takes into account the state of the public finances, the stage of the economic cycle and the growth prospects for the economy. Section 1.2 reviews the fiscal stance in *Budget 2016* based on these considerations. The medium-term fiscal stance is discussed in Section 1.3 including problems with the medium-term fiscal projections in *Budget 2016* and the Government's compliance with its own budgetary framework.

## 1.2 The Fiscal Stance in 2015 and 2016

Table 1: Summary of Main Fiscal Aggregates (General Government Basis)

| | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 |
|---|---|---|---|---|---|---|---|---|
| Main Aggregates, % of GDP | | | | | | | | |
| General Government Balance | -3.9 | -2.1 | -1.2 | -0.5 | 0.2 | 1.0 | 1.8 | 2.5 |
| Interest (% of GDP) | 4.0 | 3.2 | 3.0 | 2.9 | 2.8 | 2.6 | 2.5 | 2.3 |
| Primary balance | 0.1 | 1.1 | 1.7 | 2.3 | 3.0 | 3.6 | 4.3 | 4.8 |
| Potential output, % change (CAM)* | 2.7 | 3.4 | 4.1 | 4.3 | 3.8 | 3.3 | 3.2 | 3.5 |
| Output gap as % pot GDP (CAM) | -0.4 | 2.3 | 2.5 | 1.6 | 1.0 | 0.8 | 0.6 | 0.0 |
| Structural balance (CAM) | -3.9 | -3.4 | -2.6 | -1.4 | -0.3 | 0.6 | 1.5 | 2.5 |
| *Change in structural balance* | *0.3* | *0.5* | *0.8* | *1.1* | *1.1* | *0.9* | *0.9* | *1.1* |
| Structural primary balance (CAM) | 0.0 | -0.2 | 0.4 | 1.5 | 2.4 | 3.2 | 4.0 | 4.8 |
| *Change in primary structural balance (p.p. change)* | *0.0* | *-0.2* | *0.6* | *1.1* | *1.0* | *0.8* | *0.8* | *0.9* |
| General Government Debt | 107.5 | 97.0 | 92.8 | 90.3 | 86.7 | 83.5 | 79.8 | 75.7 |

*Source:* CSO and Department of Finance (*Budget 2016*).
*Note:* *CAM Methodology refers to the EU Commonly Agreed Methodology for estimating potential output.

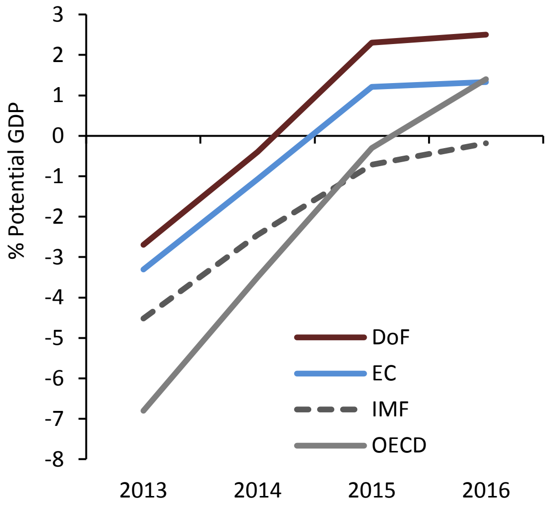
### 1.2.1 Demand Management/Debt Sustainability Trade-off

The setting of fiscal policy in recent years has required a difficult balancing of the need to support domestic demand and employment, the need to restore the State's creditworthiness and the requirement to put the public finances on a sustainable path. For most of the period from 2008 to 2014, different components of this trade-off have pulled in different directions. With output below potential and with high unemployment from 2009 to 2013, standard demand management considerations would have favoured a delay of fiscal adjustment measures in the absence of other constraints. However, the fragility of Ireland's creditworthiness and the size of the debt and deficit meant there was little option but to implement the large scale expenditure reductions and tax increases over this period. Given the improvements in the public finances and the economy in recent years, it is useful to consider an updated assessment of the different elements of the trade-off.

Turning first to the macroeconomic context for *Budget 2016,* as discussed in detail in Chapter 2, the Irish economy is currently in the midst of a buoyant recovery driven by favourable external developments as well as a pick-up in domestic economic activity. Although demand conditions in the Euro Area remain weak, the economy is benefiting from strong foreign demand from its other key trading partners – the UK and US. Ireland's external competitiveness has been boosted by the depreciation of the euro against the currencies of its main trading partners which has driven strong growth in Irish exports. Low interest rates and the fall in oil prices since 2014 are also contributing to the strength of the recovery in economic activity.

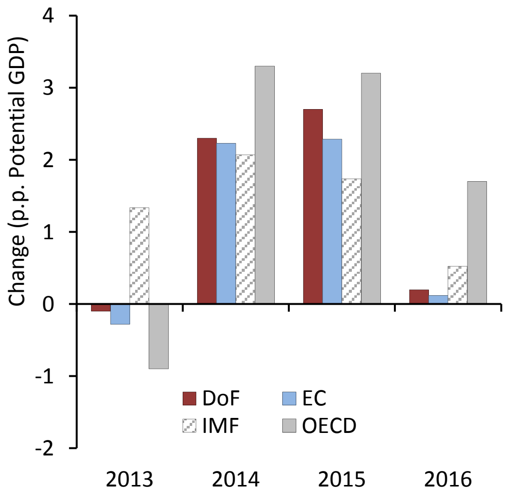
With these significant tailwinds, the central forecast from the Department of Finance on which the fiscal projections in *Budget 2016* are based is for strong growth of 6.2 per cent in 2015 and 4.3 per cent in 2016 with economic growth forecast to moderate to an average of over 3.2 per cent per annum from 2017-2021. As discussed in Chapter 2, the pace of recovery in economic activity (GNP and GDP) both this year and in 2014 has implications for the measured size of the output gap. The output gap is defined as the difference between actual and potential GDP, expressed as a share of potential GDP. A range of estimates of the output gap produced by various institutions are shown in Figure 1.1a.

FIGURE 1.1A: OUTPUT GAP ESTIMATES (% POTENTIAL GDP)




*Sources:* European Commission Autumn 2015, *Budget 2016;* IMF WEO October 2015; OECD *Economic Outlook 2015*.

FIGURE 1.1B: CHANGE IN OUTPUT GAP ESTIMATES

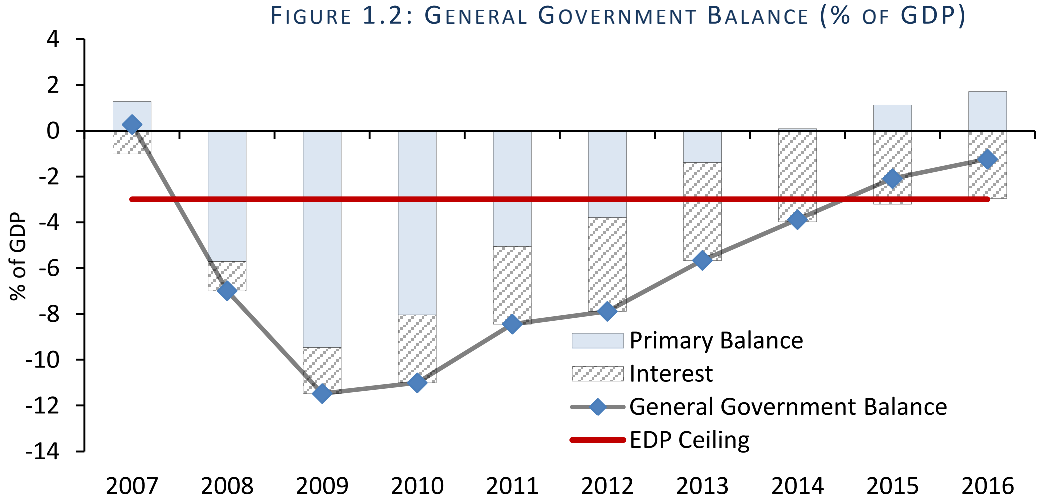



*Sources:* European Commission Autumn 2015, ; *SPU 2015;* IMF *WEO April 2015*; OECD *Economic Outlook 2015*.

The current official estimate of the output gap published in *Budget 2016* using the EU Commonly Agreed Methodology (CAM) is a positive gap of 2.3 per cent for 2015. This estimate is not consistent with a range of other indicators of imbalances in the economy. One indication that the official numbers overstate the size of any positive output gap is that the estimate of the underlying equilibrium unemployment rate (NAWRU) for 2015 is extremely high at 10.3 per cent. Estimates of the output gap from the IMF are shown in Figure 1.1a. These suggest the persistence of an output shortfall in the economy in 2015 which closes by 2016, in contrast to the Department of Finance estimates using the CAM which show a large positive output gap in 2015 and 2016.

While uncertainty surrounds the precise level and sign of the output gap currently, a more consistent picture emerges by looking at the change in the output gap (Figure 1.1b). All four estimates shown in Figure 1.1b indicate a rapid closing of the negative output gap after 2013. Furthermore, as discussed in Chapter 2, given the pace of economic growth now being observed and with domestic demand growing strongly, it appears that any remaining negative output gap in the economy will likely be eliminated over the short term. While there are currently no signs of abnormal wage or inflationary pressures requiring calming policy measures, the nature and pace of the economic recovery already underway indicates that the economy does not need a further fiscal stimulus to add to growth at this time.

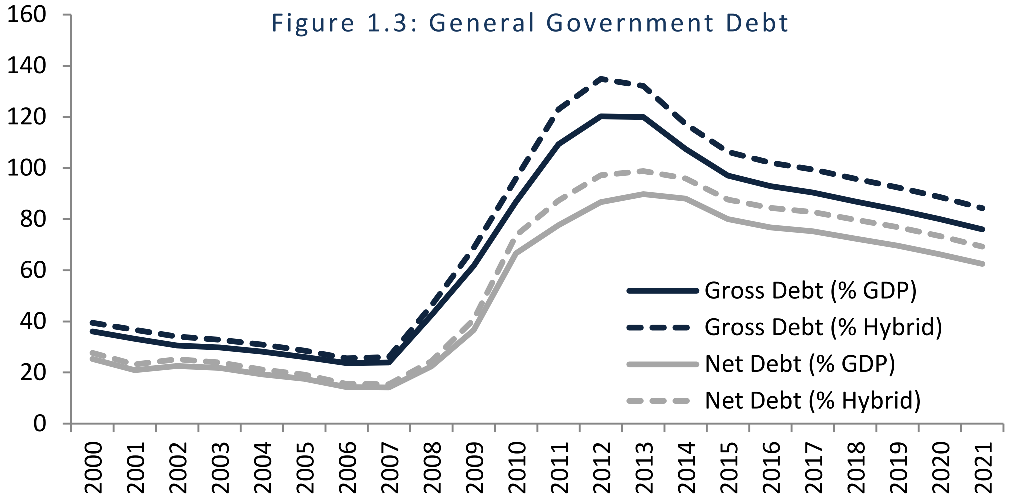
FIGURE 1.2: GENERAL GOVERNMENT BALANCE (% OF GDP)




*Source:* CSO; *Budget 2016.*

As explained in detail in Chapter 3, the public finances have continued to improve despite budgetary overruns in some areas through a combination of strong tax receipts and savings from lower debt servicing costs and falling unemployment. The General Government deficit fell to 3.9 per cent of GDP in 2014 and is expected to be around 2.1 per cent this year, despite the decision to allocate the majority of the better than expected tax revenues in 2015 towards higher expenditure.

The General Government primary balance, the deficit or surplus in the government accounts when debt servicing costs are excluded, recorded a small surplus in 2014, which is projected to increase further in 2015 and 2016 (Figure 1.2). As output grows rapidly and reflecting the reduction in cash and other financial assets, the General Government gross debt to GDP ratio has continued to fall and is expected to measure around 97 per cent of GDP by the end of 2015 compared to a peak of 120 per cent of GDP in 2013.




*Sources*: Department of Finance; internal IFAC calculations.
*Note*: Changes in EDP debt instrument assets for forecast years are assumed to be in line with *Budget 2016* projected changes in cash balances.

Despite these improvements in the public finances, further progress is needed to ensure that the debt to GDP ratio is put on a firm downward path. Ireland's debt ratio remains high by both historical and international standards. The scale of the debt burden following the crisis is even more apparent when measured as a share of GNP or the Council's hybrid measure of output (Figure 1.3).[1] A debt ratio of close to 100 per cent of GDP leaves the economy exposed to shocks that could create unsustainable debt dynamics.

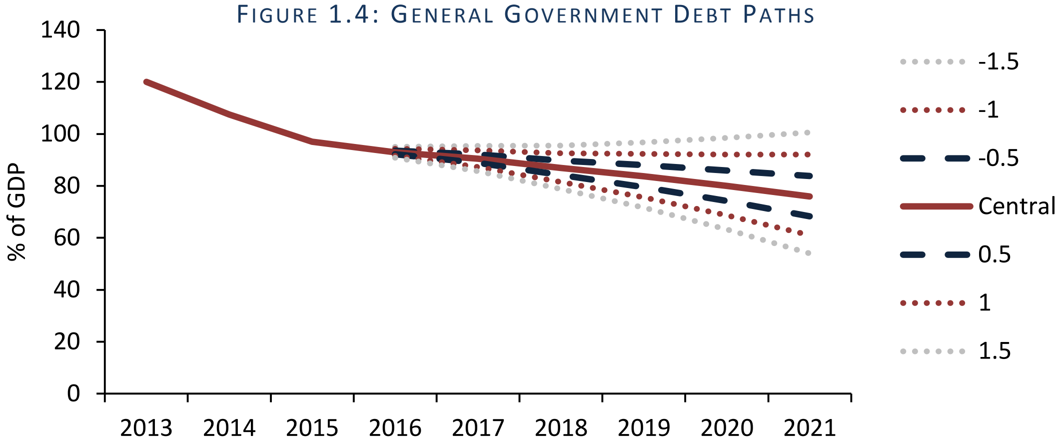
As discussed further in Chapter 2 and Chapter 3, although the near-term prospects for the economy are positive, substantial risks surround the central projections contained in the Budget. These risks stem from both internal and external sources. Among the domestic risks is the highly concentrated nature of production in the Irish economy, whereby a small number of sectors and firms account for the bulk of manufacturing output and exports.  This specialisation of Irish trade leaves the economy exposed to a potential loss of output in the event of a re-organisation of these firms' global production chains. External risks include the impact on the Irish economy of a

[1] The hybrid measure of output is an intermediate measure of fiscal capacity between GDP and GNP. It puts differential weight on GNP and the excess of GDP over GNP, defined as: H = GNP + 0.4(GDP – GNP). For details see IFAC (2012b).

slowdown in the US or UK economies or that potential growth in the Euro Area is substantially lower following the financial crisis (McQuinn and Whelan, 2015).

Were one or more of these risks to materialise, growth would be slower and unemployment higher than envisaged in current forecasts. This would make it more challenging to reduce the debt to GDP ratio in line with current projections and there is a risk that the debt could start rising again. This is illustrated in Figure 1.4 which shows the sensitivity of the debt GDP ratio to different nominal GDP growth shocks. A negative shock which resulted in nominal GDP growth being 1.5 percentage points lower than in the *Budget 2016* forecasts would see the debt to GDP ratio stagnate at its current high level before rising again by the end of the decade.

FIGURE 1.4: GENERAL GOVERNMENT DEBT PATHS




*Sources:* Department of Finance, internal IFAC calculations based on the Council's Fiscal Feedbacks Model.
*Note:* The figure shows alternative projections of the debt-to-GDP ratio based on GDP growth forecasts that deviate from *Budget 2016* projections by 0.5, 1.0 and 1.5 percentage points in either direction.

Weighing up these considerations, an assessment of the debt sustainability/demand tradeoff for 2015 suggests a less challenging context for setting fiscal policy than in recent years. The current high level of unemployment might suggest the appropriateness of an expansionary fiscal stance to ensure the economy returns to equilibrium. However, the rapid growth now being observed and the pace at which the economy's spare capacity is being reduced argue against the need for an expansionary fiscal stance. With domestic demand recovering strongly and unemployment falling, the need to eliminate the remaining budget deficit and to put the debt on a firm downward path takes clear precedence over using a more expansionary fiscal stance to stimulate an already rapidly growing economy.

### 1.2.2 THE FISCAL STANCE IN *BUDGET 2016*

The Council's assessment of the fiscal stance in *Budget 2016* covers the years 2015 and 2016. The €1.5 billion package announced on budget day on Tuesday, 13 October was at the upper limit of the €1.2 to €1.5 billion range signalled in *SPU 2015.* The more significant new information in relation to the Government's budgetary plans for 2015 and 2016 came in the White Paper published in advance of the budget on Friday, 9 October 2015. The White Paper is published annually in advance of the Budget and contains revised estimates for government revenue and expenditure for the current year along with forecasts for the following year on a no-policy change basis. In the case of this year's White Paper, the figures showed a significant increase in government expenditure for 2015 compared to earlier Government plans.

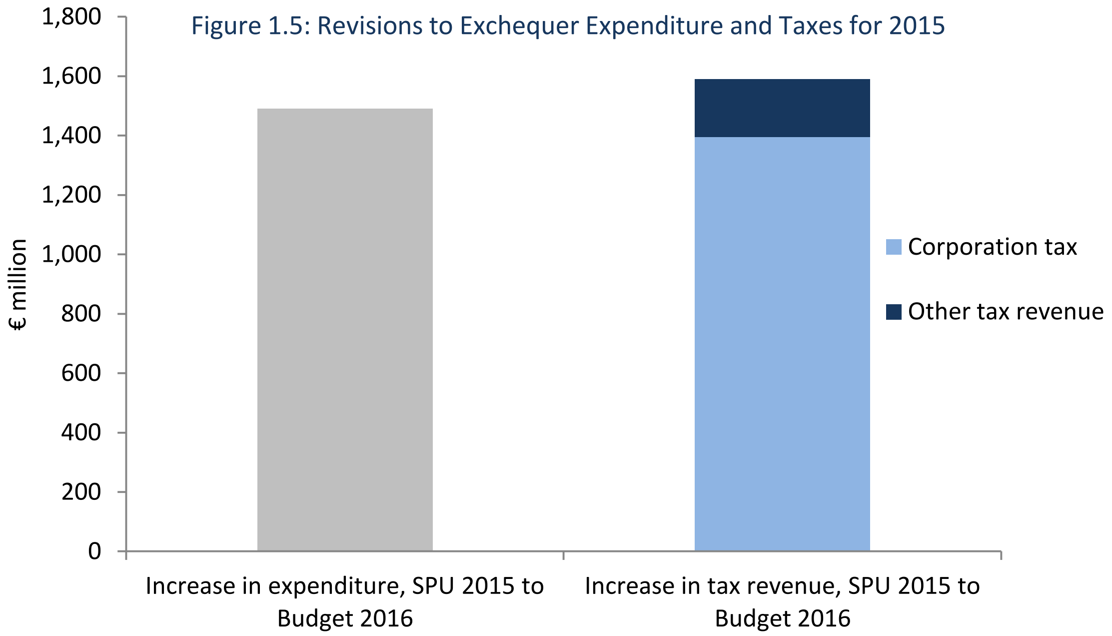
As described in Chapter 3 (Figure 3.1), *Budget 2016* contained an increase in gross current government expenditure of over 4 per cent for 2015 compared to the initial forecast for current spending in *Budget 2015.* In total, the estimate for gross current and capital expenditure in 2015 was revised up by €1.5 billion compared to *SPU 2015* (April 2015) and by €2.3 billion compared to *Budget 2015* (October 2014) (Table 2). A breakdown of the increase in spending for 2015 compared to the initial *Budget 2015* estimates shows that just under 40 per cent of the additional spending was allocated to the health area, with social protection, education and transport accounting for the bulk of the remainder.

TABLE 2: REVISIONS TO EXCHEQUER TAX REVENUE AND EXPENDITURE FOR 2015, € MILLION

| | *Budget 2015* (A) | *SPU 2015* (B) | Change (B-A) | *Budget 2016* *(C)* | Change (C-B) | Total Change (C-A) |
|---|---|---|---|---|---|---|
| **Gross Current Expenditure** | 49,034 | 49,715 | ***681*** | 51,040 | ***1,325*** | ***2,006*** |
| **Gross Capital Expenditure** | 3,550 | 3,670 | ***120*** | 3,835 | ***165*** | ***285*** |
| **Total Voted Expenditure** | 52,584 | 53,385 | ***801*** | 54,875 | ***1,490*** | ***2,291*** |
| **Exchequer Tax Revenue (Tax + PRSI)** | 50,497 | 51,497 | ***1,000*** | 53,086 | ***1,589*** | ***2,589*** |

*Note: The Budget 2015 gross voted current spending figure is adjusted to reflect the disestablishment of the HSE Vote.*

Upward revisions to spending for the current year between the budget estimate and the White Paper are not unprecedented. For 2015, the increase in expenditure to cover the overrun in the health area was in keeping with the pattern of consistent spending overruns in this area (IFAC, 2015c). Estimates of the deficit for 2015 and 2016 in IFAC's *Pre-Budget 2015 Statement* (IFAC, 2015d) incorporated an expected €600 million overrun in health spending. However, as discussed in Chapter 3, the scale of the upward revision to spending for 2015 contained in this year's White Paper was significantly greater than the expected overrun in health and was also the largest such revision recorded in recent years.

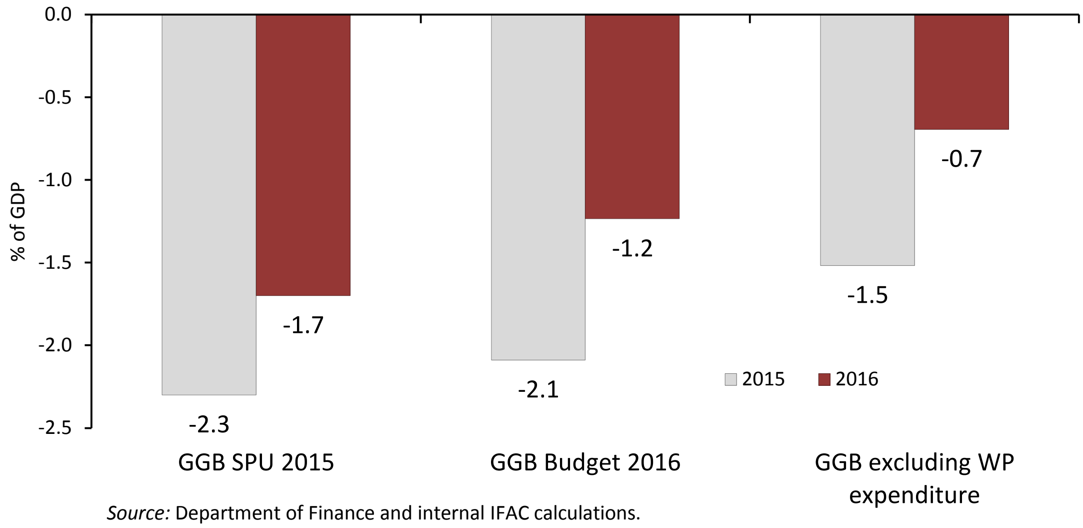



*Source:* Department of Finance and internal IFAC calculations.
*Note:* The increase in expenditure between *SPU 2015 and Budget 2016* (grey column) refers to total gross voted current and capital exenditure. Tax revenue (right hand column) is the sum of Exchequer tax revenue plus PRSI.

The announcement in *Budget 2016* of the decision to increase total gross Exchequer spending by an extra €1.5 billion in 2015 has a number of implications for assessing the fiscal stance. Since the majority of the additional current spending in 2015 is carried into the base level of spending for 2016, the overall package of budgetary measures, combining the announcements in *Budget 2016* and the White Paper, implies a significantly looser fiscal stance for both 2015 and 2016 than projected in the April 2015 *SES/SPU*.

*Budget 2016* shows that the Government expects Exchequer tax and PRSI revenues in 2015 to be €1.6 billion higher than forecast in *SPU 2015* while total gross current and capital spending is being increased by €1.5 billion compared to *SPU 2015* (Table 2). This means that the majority of the overperformance in tax revenue in 2015 (compared to the *SPU* 2015 forecast) is being used to fund higher expenditure this year (Figure 1.5). Using unexpected revenues to fund increases in expenditure goes against the spirit of the new budgetary framework and has worrying echoes of past fiscal policy errors made in Ireland during the boom. As described in Chapter 3 (see Box D), better than expected corporation tax receipts account for the majority of the overperformance in tax revenues up to September 2015 (Figure 1.5). The uncertainty at present surrounding the drivers of the corporation tax overperformance in 2015 argues against using this additional revenue to fund increases in expenditure that could be difficult to unwind.

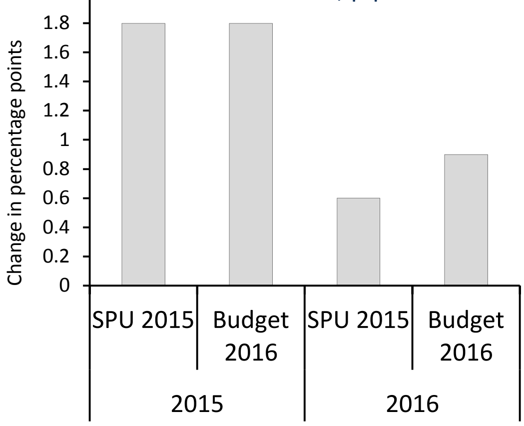
Figure 1.6: Projections for the General Government Deficit in 2015 and 2016




*Source:* Department of Finance and internal IFAC calculations.

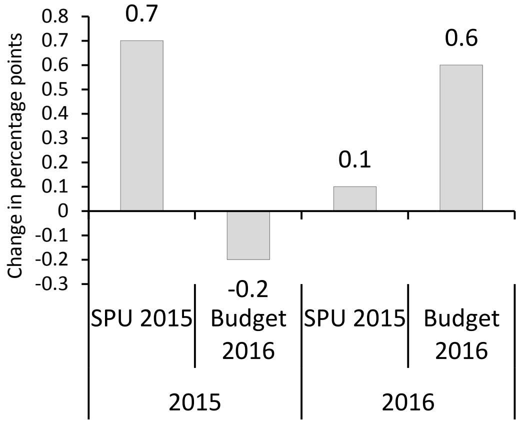
By spending a large proportion of this year's better than expected tax revenues, the opportunity to achieve a lower deficit in 2015 and 2016 has been missed. The forecast deficit for 2015 in *Budget 2016* is 2.1 per cent (compared to 2.3 per cent in *SPU 2015*). The Council's fiscal feedbacks model can be used to estimate the likely deficit for 2015 and 2016 assuming the additional spending in 2015 was used instead for deficit reduction (Figure 1.6). Had total spending not been increased in 2015, the General Government deficit would likely have been around 1.5 per cent of GDP in 2015 and a deficit of well below 1 per cent would have been attainable in 2016 (Figure 1.6). In this scenario a balanced budget would be achieved in 2017, one year earlier than projected in *Budget 2016*. All else being equal, the looser fiscal stance for 2015 than earlier planned by the Government prolongs the process of returning Ireland's high debt to lower levels at a time when the economy remains vulnerable to adverse shocks.

Figure 1.7a: Change in General Government Balance, p.p. of GDP




*Source:* Department of Finance based on EU Commonly Agreed Methodology (CAM).

Figure 1.7b: Change in Structural Primary Balance, p.p. of GDP




*Source:* Department of Finance based on Commonly Agreed Methodology (CAM).

Figure 1.7a and Figure 1.7b show the change in the headline General Government Balance and structural primary balance in 2015 and 2016 as projected in both *SPU 2015* and *Budget 2016.* Despite the significant improvement in tax revenues between the SPU in April and October, *Budget 2016* projects the same 1.8 percentage points of GDP fall in the headline deficit as contained in the *SPU* (Figure 8a).

The fiscal stance in the *Fiscal Responsibility Act (FRA)* 2012 is defined in terms of the change in the structural primary balance. The structural primary balance is an appropriate measure of the fiscal stance as it provides an estimate of the underlying budget surplus or deficit adjusting for the cyclical position of the economy. Although there is uncertainty around the level of the structural primary deficit or surplus at a point in time, assessing estimates of the change in this measure provide a more robust indicator of changes in the fiscal position rather than focusing only on the level of the structural primary deficit.

By examining revisions to the change in the structural primary balance between *SPU 2015* and *Budget 2016*, an insight can be gained into the extent of the loosening of the fiscal stance as 2015 progressed. As shown Figure 1.7b, the structural primary balance in *SPU 2015* was forecast to improve from a surplus of 0.1 per cent of GDP in 2014 to a 0.8 per cent surplus in 2015, an improvement of 0.7 percentage points.  In contrast, the revised projections in *Budget 2016* show a deterioration in the structural primary balance of 0.2 percentage points between 2014 and 2015 (Table 1 and Figure 1.7b). The expected deterioration in the budgetary position as measured by the change in the structural primary balance in *Budget 2016* is consistent with the more expansionary fiscal stance in October’s Budget compared to the planned stance in the April 2015 *SPU.*

As discussed in Chapter 3 and Chapter 4, the decision to increase spending in 2015 means that the Government's previously set expenditure ceilings will be raised. The ceilings set in *Budget 2015* (October 2014) were already increased in April 2015 in the *SPU*. The continuous within-year raising of the ceilings means that this new system for managing expenditure allocation – a core component of the Government's budgetary framework – is not being implemented effectively. The failure to implement and respect multi-annual expenditure ceilings raises the risk of funding increases in expenditure from windfall revenue sources. Proper adherence to the system of expenditure ceilings would have avoided the type of late upward revision to expenditure announced in the White Paper for 2015.

In its *Pre-Budget 2016 Statement* the Council welcomed the improvement to the budgetary process involving the announcement in April of the size of the tax and spending package for the October Budget. The announcement in April of the planned budget package of €1.2-€1.5 billion set the parameters for the discussions at the first National Economic Dialogue held in July. To protect the integrity and usefulness of the new process, it was important for the Government not to deviate from its commitment in April 2015 in respect of the pre-announced budget package. The decision to increase expenditure in 2015 beyond the plan announced in the *Spring Economic Statement* undermines this new reform to the budgetary process.

Ireland is in an unusual position in 2015 regarding compliance with the fiscal rules as this is the final year of the Excessive Deficit Procedure (EDP) and the Expenditure Benchmark does not apply (see Box F in Chapter 4). The only binding rule in 2015 is the requirement to reduce the deficit to below the 3 per cent EDP ceiling. Had the requirements of the Preventive Arm of the SGP (which will apply from 2016 onwards) been in effect in 2015, neither the required improvement in the structural balance or the Expenditure Benchmark rules would have been complied with.

The Council has a responsibility under the *FRA* to assess whether "...the fiscal stance for the year or years concerned is....conducive to prudent economic and budgetary management" [FRA 8(4)(b)]. This assessment covers both 2015 and 2016. While the planned stance from 2016 meets the requirements of the rules, the Council assesses that the move to a more expansionary fiscal stance in 2015 than was envisaged in the April *SPU* was a deviation from prudent economic and budgetary management. The decision to increase spending in 2015 on foot of better than expected tax revenues goes against the spirit of the fiscal rules and results in extra borrowing and a higher deficit than could have been achieved had the revenues been used for debt reduction. While the fiscal stance in 2015 would not lead to a formal breach of any of the requirements of the *Stability and Growth Pact* based on current official projections, the increase in spending for 2015 undermines the domestic expenditure ceilings.

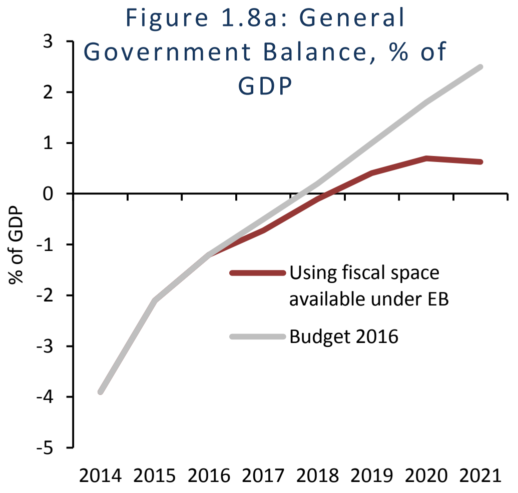
Despite starting from a less favourable position than could have been achieved in 2015, the fiscal stance for 2016 and later years is consistent with the deficit and debt remaining on a downward path. The Council's September 2015 *Pre-Budget Statement* assessed that the planned budget package for 2016 in the *Spring Economic Statement (SES)* was within the range of prudent policies from an economic perspective. *Budget 2016* contained a €1.5 billion package of planned spending increases and tax cuts for 2016 in line with the plan outlined in the Government's *SES* in April. As this package comes on top of the increase in spending for 2015, the fiscal stance in 2016 is less prudent than planned in the *SES*. Nevertheless, government revenues in 2016 are forecast to grow at a higher pace than non-interest government spending by some margin, which is appropriate given the on-going recovery. The projections signal an intention to comply with the Preventive Arm of the *Stability and Growth Pact (SGP)* and the domestic Budgetary Rule, which would be consistent with prudent policy.

## 1.3 The Medium-Term Fiscal Stance

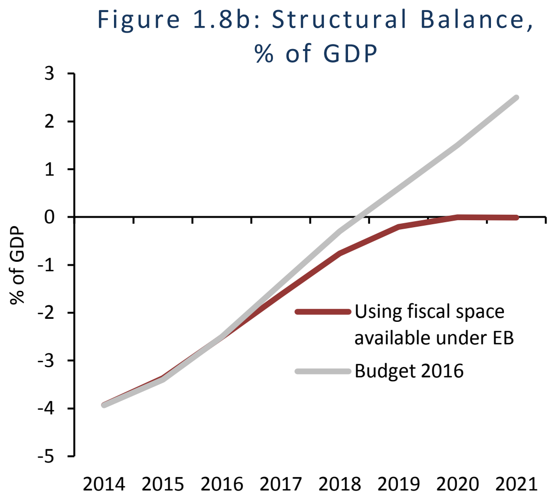
As stated in the April 2015 *SPU* and *Spring Economic Statement*, over the medium term the Government's intention is to comply with the minimum requirements to achieve its medium-term objective (MTO) of a balanced budget in structural terms. On the basis of official estimates of the structural balance published in *Budget 2016,* the minimum requirements would imply a 0.75 per cent reduction in the structural deficit in 2017 with 0.6 per cent annual improvements required thereafter until the MTO is reached.

The projections in *Budget 2016* show improvements in the structural deficit significantly in excess of these requirements despite the stated Government commitment to target minimum compliance. The difference between the forecasts in *Budget 2016* and what is required for minimum compliance corresponds to an estimate of the additional fiscal space that will be available under the rules to address spending pressures and Government policy commitments.

*Budget 2016* provides estimates of the additional fiscal space that would be available (under the Expenditure Benchmark) after 2016 consistent with the Government policy of minimum compliance. However, as discussed in Chapter 3, the budget forecasts do not show the resulting path for the public finances assuming this fiscal space is used for expenditure increases and/or tax reductions. Figure 1.8a and Figure 1.8b below show the path of the actual and structural deficits compared to the projections in *Budget 2016*. Assuming that fiscal policy is set in accordance with the stated policy of meeting minimum rule compliance, there would be larger headline budget deficits over the 2017 to 2019 period and the budget surplus by 2021 would be almost two percentage points smaller than in the *Budget 2016* projections. The scenarios for the structural deficit are shown in Figure 1.8b. Under the Budget forecasts, the Government would come close to meeting its MTO (of a balanced budget in structural terms) by 2018. Assuming the Government use the fiscal space identified in *Budget 2016*, the MTO would not be reached until one year later in 2019.




*Note:* The red line shows the path of the General Government Balance assuming the estimated fiscal space under the Expenditure Benchmark (EB) as calculated in *Budget 2016* is used.
*Source: Budget 2016* and internal IFAC calculations.




*Note:* The red line shows the path of the structural balance assuming the estimated fiscal space under the EB as calculated in *Budget 2016* is used.
*Source: Budget 2016* and internal IFAC calculations.

In providing medium-term projections for the public finances, the Government should ensure that these reflect actual Government policy intentions along with the Department's best assessment of the likely future path of deficit. This is essential if the forecasts contained in the Budget are to provide a meaningful anchor for medium-term budgetary planning.

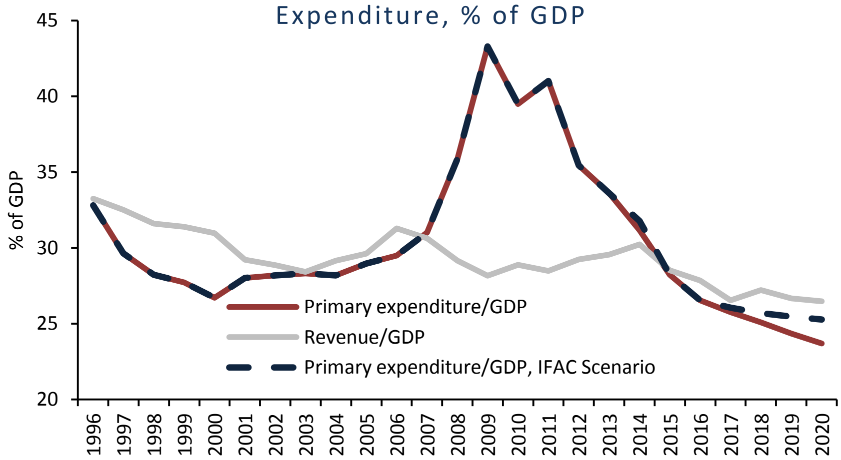
A key weakness of fiscal policy making in Ireland prior to the crisis was that the budgetary process paid insufficient attention to medium-term expenditure management. This is acknowledged in the Department of Finance's 2011 document *Reforming Ireland's Budgetary Process.*[2] In this context, the Government's failure to implement the new system of multi-annual expenditure ceilings – the key crisis reform designed to address the previous failure of expenditure management – is of serious concern to the Council. As discussed in Chapter 4, the continuous upward revisions to the ceilings since their introduction undermine multi-annual expenditure management and is not consistent with best practice expenditure planning. The expenditure ceilings were also designed as a way to implement the Expenditure Benchmark, a key component of the Government's budgetary framework. Recognising the weakness of the domestic expenditure ceilings in controlling spending,

[2] Available here: http://www.finance.gov.ie/sites/default/files/budgetref.pdf

there are risks to compliance with the EB in 2016 since there is no buffer. The Medium-Term Expenditure Framework should be strengthened and the Government should commit to the system of multi-annual expenditure management if the mistakes of the past are to be avoided.

Following exit from the *Excessive Deficit Procedure (EDP)* in 2015, Ireland's national budgetary framework comprising the domestic Budgetary rule – which mirrors the requirements of the Preventive Arm of the *SGP* – along with the expenditure ceilings will come into operation. As outlined in previous Fiscal Assessment Reports (IFAC 2014a, 2015b), despite its complexity and imperfections in some areas, the budgetary framework provides a valuable structure to guide Irish fiscal policy. Evidence from the international literature indicates that commitment to a strong fiscal framework can promote an improved fiscal performance by helping to counteract the pressures that lead to deficit bias and procyclical fiscal policy (Fabrizio and Mody, 2006). There is also some evidence that credible independent fiscal institutions in tandem with a strong budgetary framework can contribute to improve the conduct of fiscal policy (European Commission, 2006).

Figure 1.9: Government Revenue and Primary Expenditure, % of GDP




*Note:* Chart shows exchequer revenue and primary expenditure as a share of GDP.
*Source: Budget 2016* and internal IFAC calculations.

A core requirement of Ireland's budgetary framework is the need to provide credible medium-term plans for the public finances. As explained by the Council in successive *Fiscal Assessment Reports* (IFAC, 2014b, IFAC, 2015b), a major weakness of Government plans set out in recent budgets and Stability Programme Updates is the absence of a realistic medium-term plan for the public finances. This weakness has not been addressed in *Budget 2016.* The Government's current projections for the public finances, based on technical assumptions, imply an implausibly large squeeze on government spending over the medium term, with the ratio of government spending to GDP projected to fall by over 5 percentage points by 2021. The tax forecasts do not reflect commitments announced in *Budget 2016,* including the plan to abolish the Universal Social Charge (USC).

As demonstrated in the Council's June 2015 report and in Chapter 3 of this Report, the profile for government spending in *Budget 2016* is not realistic taking into account increases in the cost of maintaining existing public services and higher demand for additional services due to demographic and other cost pressures (Figure 1.9). Based on the projections in *Budget 2016,* the analysis in Chapter 3 illustrates that meeting likely future expenditure needs would absorb the majority of the estimated fiscal space available after 2016. Further tax cuts would make it very difficult to fund these expenditure pressures while complying with the rules.